

## Message Text

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ACTION EA-09

INFO OCT-01 IO-11 ISO-00 AID-05 CIAE-00 COME-00 EB-07

FRB-03 INR-07 NSAE-00 USIA-06 TRSE-00 XMB-02 OPIC-03

SP-02 CIEP-01 LAB-04 SIL-01 OMB-01 DODE-00 AGR-05

NSC-05 SS-15 STR-04 CEA-01 PA-01 PRS-01 /095 W

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R 222345Z JAN 76

FM AMEMBASSY SEOUL

TO SECSTATE WASHDC 5084

INFO CINCPAC

USDEL MTN GENEVA

AMEMBASSY TAIPEI

AMEMBASSY TOKYO

C O N F I D E N T I A L SECTION 1 OF 3 SEOUL 0478

CINCPAC FOR POLAD, PASS TO AMBASSADOR SNEIDER

EO 11652: GDS

TAGS: EGEN, EFIN, MASS, MPOL, MTN, KS

SUBJECT: KOREAN ECONOMY UP 7.4 PERCENT IN 1975; LESS

INFLATION AND GROWTH OF 7 PERCENT TARTETED FOR 1976

REFS:

A. SEOUL 0375 DTG 160443Z JAN 76

B. SEOUL 0429 DTG 200031Z JAN 76

C. SEOUL 10006 DTG 310230Z DEC 75 (NOTAL)

D. SEOUL 6240 DTG 140840Z AUG 75 (NOTAL)

SUMMARY: BOLSTERED BY THE SECOND HALF RECOVERY IN THE  
EXPORT SECTOR AND BUMPER GRAIN CROPS, PRELIMINARY  
ESTIMATES SHOW THE KOREAN ECONOMY GROWING BY 7.4 PERCENT  
IN 1975, DOWN SLIGHTLY FROM 8.6 PERCENT IN 1974.

CONTINUED EXPORT EXPANSION IS COUNTED ON TO PACE  
FURTHER GROWTH OF AT LEAST 7.0 PERCENT IN 1976.

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AFTER RECORDING A SECOND STRAIGHT YEAR OF INFLATION

OF ROUGHLY 25 PERCENT (ON A GNP DEFLATOR BASIS), SLOWING INFLATION TO 15 PERCENT OR LESS WILL BE A KEY TARGET FOR 1976. TO ACHIEVE THE TWIN OBJECTIVES OF GREATER PRICE STABILITY AND CONTINUED GROWTH FOR 1976, THE ROKG PLANS TO CUT ITS FISCAL DEFICIT, DESPITE A STEEP CLIMB IN DEFENSE OUTLAYS, INCREASE DOMESTIC SAVINGS AND HOLD A FIRM LINE ON DOMESTIC CREDIT AND MONETARY EXPANSION. THE ROKG PERFORMANCE IN THESE AREAS WAS GENERALLY GOOD OVER THE FINAL HALF OF 1975, BUT CONTINUED DELAY IN REDUCING THE GRAIN MANAGEMENT FUND DEFICIT AND IN DEALING WITH INTEREST RATE POLICIES COULD BE TROUBLESOME. END SUMMARY

1. THIS MESSAGE IS THE THIRD OF THE THREE MESSAGES ON THE KOREAN ECONOMY CITED IN REF A, AND DEALS WITH INTERNAL DEVELOPMENTS.

2. 1975 RESULTS: ACCORDING TO PRELIMINARY BANK OF KOREA ESTIMATES, REAL GNP GREW 7.4 PERCENT IN 1975, DOWN ONLY SLIGHTLY FROM 8.6 PERCENT IN 1974. ANTI-RECESSION FISCAL MEASURES TO STIMULATE THE ECONOMY EARLY IN 1975, THOUGH THEY HAD TO BE REDUCED BECAUSE OF BOP PRESSURE, WERE FOLLOWED BY RESUMED EXPORT GROWTH AND BUMPER GRAIN CROPS LATER IN THE YEAR TO PRODUCE THE HIGHER THAN EXPECTED 1975 GNP GROWTH RATE (EVEN THE OFFICIAL FIGURE MAY WELL BE LOW AS THE ROKG ARBITRARILY REVISED ITS ESTIMATING SYSTEM IN A WAY WHICH TENDED TO REDUCE THE IMPACT OF THE SHARP CLIMB IN OUTPUT DURING THE LAST QUARTER). PER CAPITA GNP IN 1975 IN CURRENT PRICES IS ESTIMATED AT \$531 AS COMPARED TO \$483 IN 1974, USING REVISED HIGHER POPULATION ESTIMATES CURRENTLY EMPLOYED BY ROKG PLANNING AGENCIES.

3. BASED ON PRELIMINARY DATA, THE MANUFACTURING SECTOR GREW BY 11.8 PERCENT FOR 1975 WITH EXPORT-ORIENTED INDUSTRIES LEADING THE WAY OVER THE FINAL SIX MONTHS. THE SECOND HALF REBOUND FOR SUCH LABOR INTENSIVE INDUSTRIES AS TEXTILES, ELECTRONICS AND PLYWOOD EASED UNEMPLOYMENT AND UNDEREMPLOYMENT PROBLEMS THAT HAD BEGUN DEVELOPING IN THE LATTER PART OF 1974. PRIVATE

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CONSTRUCTION, ESPECIALLY HOUSING, HIT NEW HEIGHTS IN TERMS OF PERMITS ISSUED DURING THE FIRST HALF OF 1975 AS A RESULT OF GOVERNMENT ANTI-RECESSION MEASURES. DURING THE SECOND HALF, HOWEVER, AS FISCAL RESTRAINT BEGAN TO TAKE EFFECT, NEW CONSTRUCTION PERMITS FELL BACK TO MORE NORMAL LEVELS, SO THAT FOR THE YEAR AS A WHOLE CONSTRUCTION ROSE ONLY A MODERATE 6.5 PERCENT ABOVE 1974 IN REAL TERMS. ACTIVITY IN 1975 IN THE

SOCIAL OVERHEAD CAPITAL SECTOR, REFLECTING PRIMARILY COUNTERCYCLICAL FIRST HALF 1975 GOVERNMENT SPENDING FOR PUBLIC WORKS, WAS NEARLY 13 PERCENT HIGHER THAN 1974. PRODUCTION IN AGRICULTURE, FORESTRY AND FISHING COMBINED WAS UP 6.2 PERCENT IN 1975 OVER 1974 (THOUGH SPOT EVALUATIONS OF BOTH OUTPUT AND VALUE ADDED IN AGRICULTURE SUGGEST THE ESTIMATE IS HIGH). EXCEPTIONAL CROPS OF RICE AND BARLEY ACCOUNTED FOR MOST OF THIS GAIN, HELPING TO OFFSET LACKLUSTER FISHERIES PRODUCTION, ESPECIALLY FROM OFFSHORE FISHING.

4. FISCAL DEVELOPMENTS. LARGELY AS A RESULT OF A COMBINED DEFICIT IN EXTRABUDGETARY ACCOUNTS OF 350 BILLION WON, PRINCIPALLY IN THE GRAIN MANAGEMENT FUND (GMF) AND THE FERTILIZER ACCOUNT, THE OVERALL FISCAL DEFICIT FOR 1975 IS ESTIMATED AT 380 BILLION WON, UP SHARPLY FROM THE 138 BILLION WON GAP RECORDED IN 1974. GENERAL BUDGET EXPENDITURES ROSE 63 PERCENT FOR THE YEAR, REFLECTING THE FIRST HALF COUNTERCYCLICAL MEASURES AND A STEEP SECOND HALF INCREASE IN DEFENSE OUTLAYS. THE INCREASED DEFENSE EXPENDITURES ARE RELATED TO A ROKG DECISION TO UP GRADE ITS OWN DEFENSE EFFORT IN THE AFTERMATH OF THE FALL OF INDOCHINA. FOR 1975 AS A WHOLE, DEFENSE EXPENDITURES INCREASED 56 PERCENT OVER 1974, OR 25.3 PERCENT IN REAL TERMS, AND BUDGETED DEFENSE EXPENDITURES REPRESENTED 5.1 PERCENT OF GNP COMPARED TO 4.4 PERCENT IN 1974. MUCH OF THIS INCREASE IN 1975 GENERAL BUDGET EXPENDITURES WAS COVERED BY A 55 PERCENT RISE IN REVENUES, WHICH WERE BOLSTERED BY A SERIES OF NEW TAX LEVIES INTRODUCED DURING THE SUMMER AND KNOWN COLLECTIVELY AS THE "DEFENSE TAX". PRELIMINARY FIGURES SHOW A 30 BILLION WON DEFICIT FOR THE 1975 GENERAL BUDGET (EXCLUDING THE EXTRABUDGETARY

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ACCOUNTS) AS COMPARED TO THE 31 BILLION WON SURPLUS ACHIEVED IN 1974. THE TAX BURDEN AS A RATIO OF CURRENT GNP, EXCLUDING LOCAL GOVERNMENT LEVIES, ROSE TO 15 PERCENT IN 1975, UP FROM 13.5 PERCENT IN 1974 AND 11.7 PERCENT IN 1973.

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NSC-05 SS-15 STR-04 CEA-01 PA-01 PRS-01 /095 W

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R 222345Z JAN 76

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5. CREDIT AND MONEY SUPPLY. DESPITE THE LARGE OVERALL FISCAL DEFICIT, A TIGHT REIN ON DOMESTIC CREDIT TO THE PRIVATE SECTOR OVER THE FINAL HALF OF THE YEAR HELD FULL YEAR GROWTH IN OVERALL DOMESTIC CREDIT TO 32.5 PERCENT, DOWN MARKEDLY FROM 1974'S 54 PERCENT. INTEREST RATES IN THE CURB MARKET HAVE REPORTEDLY RISEN TO WELL OVER 30 PERCENT, P.A., VERSUS THE EFFECTIVE COMMERCIAL BANK PRIME RATE OF 17 TO 19 PERCENT AS THIS CREDIT SQUEEZE HAS TIGHTENED. THE MONEY SUPPLY ROSE 25.6 PERCENT FOR THE YEAR, WITH MOST OF THE INCREASE OCCURRING IN THE LATER HALF OF THE YEAR REFLECTING THE RISE IN NET FOREIGN ASSETS.

6. SAVINGS AND INVESTMENT. WITH GOVERNMENT INVESTMENT ACTIVITY FALLING OFF SHARPLY BEYOND MID-YEAR, COUPLED WITH THE GENERAL STAGNATION IN PRIVATE INVESTMENT, OTHER THAN HOUSING, INVESTMENT AS A RATIONN OF CURRENT GNP FELL FROM 31.3 PERCENT IN 1974 TO 27.2 PERCENT IN 1975. WHILE PRESENT ESTIMATES SHOW FOREIGN SAVINGS DROPPING FROM 13.5 PERCENT TO ABOUT 11.4 PERCENT OF  
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CURRENT GNP, PRELIMINARY FIGURES SHOW DOMESTIC SAVING ALSO FALLING 1.1 PERCENT TO 18.1 PERCENT. THE LATTER RATION IS DOWN FROM A PEAK OF 22 PERCENT IN 1973 AND HAS PRODUCED AN EXPRESSION OF CONCERN FROM SUCH

INTERNATIONAL ORGANIZATIONS AS THE IMF AND THE IBRD. THEIR ANALYSIS FOCUSES PRIMARILY ON INTEREST RATE POLICIES WHICH HAVE PERMITTED THE OFFICIAL INTEREST RATE STRUCTURE TO BECOME NEGATIVE IN REAL TERMS AND ON THE DECLINE IN NET PUBLIC SAVINGS FROM A RATIO OF 6 TO 7 PERCENT IN THE LATE 1960'S AND EARLY 1970'S TO 3 TO 4 PERCENT OVER THE PAST SEVERAL YEARS (PRELIMINARY 3.7 PERCENT IN 1975), CHIEFLY REFLECTING THE HUGE DEFICITS IN EXTRABUDGETARY ACCOUNTS RESULTING FROM THE GRAIN AND FERTILIZER SUBSIDIES. THE FERTILIZER SUBSIDY ISSUE WAS LARGELY RESOLVED WITH THE ANNOUNCEMENT OF A WHOPPING 79.2 PERCENT INCREASE IN FERTILIZER SELLING PRICES IN DECEMBER WHICH IS EXPECTED TO ELIMINATE THE FERTILIZER ACCOUNT DEFICIT IN 1976. CURRENT PLANS CALL FOR ELIMINATION OF THE OPERATING DEFICIT IN THE GMF AS WELL, BUT DETAILS OF HOW THIS IS TO BE DONE ARE STILL UNCLEAR. (ONE ESTIMATE IS THAT IT WILL REQUIRE A 30 PERCENT HIKE IN SELLING PRICES FOR GRAINS SOMETIME DURING THE FIRST HALF OF 1976 TO OFFSET THE 24 PERCENT INCREASE IN THE RICE BUYING PRICE ANNOUNCED IN NOVEMBER.)

7. PRICES. THE SHIFT TO MORE RESTRICTIVE FISCAL AND CREDIT POLICIES, BEGINNING IN THE SECOND QUARTER, HELPED EASE SOME OF THE INFLATIONARY PRESSURES IN THE KOREAN ECONOMY BEYOND MID-YEAR. WHOLESALE AND RETAIL PRICES WHICH HAD RISEN BY 14.1 PERCENT AND 16.8 PERCENT RESPECTIVELY THROUGH JUNE FINISHED THE YEAR WITH INCREASES OF 20.2 PERCENT AND 25.4 PERCENT RESPECTIVELY (DECEMBER-TO-DECEMBER BASIS). THESE FIGURES COMPARE TO GAINS OF 44.6 PERCENT FOR WHOLESALE PRICES AND 26.4 PERCENT FOR RETAIL PRICES IN 1974. INFLATION AS MEASURED BY THE GNP DEFLATOR WAS 24.4 PERCENT FOR 1975, DOWN SLIGHTLY FROM THE 26.7 PERCENT FIGURE RECORDED IN 1974. HOWEVER, THE INITIAL IMPACT OF THE DEFENSE TAX LEVY (SEE ABOVE), COMBINED WITH INCREASES IN PRICES FOR SUCH KEY COMMODITIES AS GRAINS, FERTILIZER AND PETROLEUM PRODUCTS,

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WERE CREATING NEW PRESSURE ON OTHER DOMESTIC PRICES AS THE YEAR CLOSED.

8. 1976 OUTLOOK. FORMAL ROKG PLANS FOR 1976, DUE TO BE RELEASED SHORTLY, ARE EXPECTED TO GIVE HIGH PRIORITY TO SLOWING THE INFLATION RATE TO 15 PERCENT ON A GNP DEFLATOR BASIS AND TO 12 PERCENT OR LESS FOR WHOLESALE PRICES (ABOUT 10 PERCENT ON A DECEMBER -TO-DECEMBER BASIS). TO ACHIEVE THIS AIM, KOREAN PLANNERS ENVISAGE A POSTURE OF GENERAL RESTRAINT WITH CONTINUED EXPORT EXPANSION AND INCREASED EMPHASIS ON IMPORT SUBSTITUTION

PACING A PROJECTED INCREASE OF 7 PERCENT (OR POSSIBLY 8 PERCENT) IN REAL GNP. IN A LAST MINUTE CHANGE, EXPANSION OF DOMESTIC CREDIT HAS NOW BEEN TARTETED AT 26 PERCENT (FURTHER CURTAILED FROM THE 30 PERCENT TARGET REPORTED IN REF A). GROWTH IN MONEY SUPPLY IS TARGETED AT 20 PERCENT. THE STRENGTHENED PRICE CONTROLS RECENTLY ADOPTED (SEE REF C) ARE VIEWED AS A SUPPLEMENTARY TOOL.

9. DESPITE A BUDGETED RISE OF 52 PERCENT IN DEFENSE EXPENDITURES AND 50 PERCENT FOR GOVERNMENT PAY INCLUDING BONUSES, REFLECTING RESPECTIVELY A CONTINUATION OF THE HEIGHTENED DEFENSE EFFORT CITED ABOVE AND AN ROKG COMMITMENT TO RAISE GOVERNMENT SALARIES AS PART OF AN ANTI-CORRUPTION CAMPAIGN, THE OVERALL FISCAL DEFICIT FOR 1976 IS PROJECTED TO NARROW BY OVER 200 BILLION WON TO APPROXIMATELY 170 BILLION WON. THIS IS TO BE ACCOMPLISHED AT THE EXPENSE OF A DECLINE IN REAL TERMS FOR CAPITAL EXPENDITURES COMBINED WITH THE ELIMINATION OF THE DEFICIT IN THE FERTILIZER ACCOUNT AND THE OPERATING DEFICIT IN THE GRAIN MANAGEMENT FUND (SEE PARA 6 ABOVE). THE RESULTING RISE IN PUBLIC SECTOR SAVING IS EXPECTED TO PRODUCE AN INCREASE OF ROUGHLY 1 PERCENTAGE POINT TO 19 PERCENT FOR THE DOMESTIC SAVINGS RATIO. WITH THE FOREIGN SAVINGS RATION TARGETED TO FALL TO 7 PERCENT, GROSS INVESTMENT AS A RATION OF CURRENT GNP IS EXPECTED TO FALL SLIGHTLY TO 26 PERCENT.

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FRB-03 INR-07 NSAE-00 USIA-06 TRSE-00 XMB-02 OPIC-03

SP-02 CIEP-01 LAB-04 SIL-01 OMB-01 DODE-00 AGR-05

NSC-05 SS-15 STR-04 CEA-01 PA-01 PRS-01 /095 W

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10. COMMENT: THE EMPHASIS ON RESTRAINING INFLATION IS CLEARLY DESIRABLE, BUT THE ROKG'S TARGETS MAY BE DIFFICULT TO ACHIEVE, PARTICULARLY IN LIGHT OF THE ADDED BURDEN OF SHARPLY INCREASED DEFENSE EXPENDITURES. SOME QUARTERS EXPRESS CONCERN THAT ADMINISTRATIVE MACHINERY WILL BE USED TO TEMPORARILY HOLD DOWN KEY PRICES IN THE VARIOUS PRICE INDICES BUT A SUBSEQUENT SURGE IN PRICES IS INEVITABLE ONCE THOSE CONTROLS ARE LIFTED. PRESSURE FOR DEVALUATION OF THE WON CAN BE EXPECTED TO GROW UNLESS THERE IS DEMONSTRABLE SUCCESS IN THE EFFORT TO REIN IN INFLATION.

11. ROKG OFFICIALS RECOGNIZE THAT THEIR COUNTER-CYCLICAL POLICIES OF LATE 1974 AND EARLY 1975 PRODUCED MORE STIMULUS THAN THEY HAD ANTICIPATED. THE DEGREE OF FISCAL AND MONETARY RESTRAINT EXERCISED OVER THE FINAL HALF OF THE YEAR, HOWEVER, ENABLED KOREA TO STAY WITHIN ALL CEILINGS FOR JANUARY 1, 1976, ESTABLISHED IN THE CURRENT JUNE-TO-JUNE IMF STANDBY AGREEMENT (SEE REF D). THE EXPORT RECOVERY HAS HELPED  
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CONSIDERABLY TO RESTORE MORE BALANCED MOMENTUM TO THE ECONOMY AND ROKG PLANNERS ARE QUITE CONFIDENT THEY CAN ACHIEVE (AND CONFIDE THEY EXPECT TO EXCEED) THE 1976 GROWTH TARGET OF 7 PERCENT WHILE STILL MAINTAINING A REASONABLE DEGREE OF RESTRAINT ON THE FISCAL AND MONETARY LEVERS.

12. TUN THIN, CHIEF OF THE ASIAN DEPARTMENT OF THE IMF, INFORMALLY REVIEWED ROKG PLANS FOR 1976 DURING A VISIT TO KOREA AT YEAR'S END. WE UNDERSTAND HE LEFT WITH A GENERALLY FAVORABLE IMPRESSION WITH TWO EXCEPTIONS. THE FIRST CONCERNS THE LACK OF SPECIFIC PLANS FOR COMING TO GRIPS WITH THE GMF DEFICIT AND THE SECOND INVOLVES THE ROKG FAILURE TO REVISE INTEREST RATE POLICIES. WITH REGARD TO INTEREST RATE POLICY, ROKG OFFICIALS CONTINUE TO BE EXTREMELY RELUCTANT TO RAISE LENDING RATES ON THE GROUNDS: (1) THAT IT WOULD BE INTERPRETED AS LACK OF CONFIDENCE BY THE GOVERNMENT IN ITS OWN INFLATION TARGETS, AND (2) THAT IT WOULD DAMAGE THE COMPETITIVE POSITION OF KOREAN EXPORTERS, WHO ARE THE MAJOR RECIPIENTS OF COMMERCIAL BANK

CREDIT AT LOW INTEREST. IN EFFECT, THE ROKG HOPES TO RESOLVE THE PROBLEM BY SLOWING INFLATION SUFFICIENTLY TO RESTORE POSITIVE REAL INTEREST RATES WITHIN THE EXISTING NOMINAL LENDING RATE STRUCTURE. IN THE INTERIM, SCHEMES TO RAISE DEPOSIT RATES TO ATTRACT ADDITIONAL SAVINGS WHILE HOLDING LENDING RATES AT CURRENT LEVELS ARE BEING DISCUSSED. FOR EXAMPLE, ONE PROGRAM JUST ANNOUNCED WILL GIVE LOW-INCOME DEPOSITORS 23 TO 25 PERCENT ANNUAL INTEREST ON 3 TO 5 YEAR SPECIAL SAVINGS DEPOSITS RESPECTIVELY, COMPARED TO PRESENT 15 PERCENT RATE ON TIME DEPOSITS, WITH THE GOVERNMENT TO SUBSIDIZE INTEREST AS NECESSARY BEGINNING IN 1979 AS THE FIRST WITHDRAWALS BEGIN. THESE ARE LITTLE MORE THAN PALLIATIVES, AS THE ROKG HAS MIXED ITS OBJECTIVES OF TRANSFERRING INCOME TO THE POOR WITH INCREASING SAVINGS AND IN THE PROCESS HAS TAKEN EVERYONE'S EYE OFF THE REAL ISSUE, THE NEGATIVE REAL LENDING RATES.

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## Message Attributes

**Automatic Decaptioning:** X  
**Capture Date:** 01 JAN 1994  
**Channel Indicators:** n/a  
**Current Classification:** UNCLASSIFIED  
**Concepts:** ECONOMIC CONDITIONS, INFLATION, INTEREST RATES, ECONOMIC PROGRAMS, INVESTMENTS  
**Control Number:** n/a  
**Copy:** SINGLE  
**Draft Date:** 22 JAN 1976  
**Decaption Date:** 01 JAN 1960  
**Decaption Note:**  
**Disposition Action:** RELEASED  
**Disposition Approved on Date:**  
**Disposition Authority:** morefirh  
**Disposition Case Number:** n/a  
**Disposition Comment:** 25 YEAR REVIEW  
**Disposition Date:** 28 MAY 2004  
**Disposition Event:**  
**Disposition History:** n/a  
**Disposition Reason:**  
**Disposition Remarks:**  
**Document Number:** 1976SEOUL00478  
**Document Source:** CORE  
**Document Unique ID:** 00  
**Drafter:** n/a  
**Enclosure:** n/a  
**Executive Order:** GS  
**Errors:** N/A  
**Film Number:** D760023-0750  
**From:** SEOUL  
**Handling Restrictions:** n/a  
**Image Path:**  
**ISecure:** 1  
**Legacy Key:** link1976/newtext/t19760131/aaaabbcn.tel  
**Line Count:** 403  
**Locator:** TEXT ON-LINE, ON MICROFILM  
**Office:** ACTION EA  
**Original Classification:** CONFIDENTIAL  
**Original Handling Restrictions:** n/a  
**Original Previous Classification:** n/a  
**Original Previous Handling Restrictions:** n/a  
**Page Count:** 8  
**Previous Channel Indicators:** n/a  
**Previous Classification:** CONFIDENTIAL  
**Previous Handling Restrictions:** n/a  
**Reference:** n/a  
**Review Action:** RELEASED, APPROVED  
**Review Authority:** morefirh  
**Review Comment:** n/a  
**Review Content Flags:**  
**Review Date:** 07 JAN 2004  
**Review Event:**  
**Review Exemptions:** n/a  
**Review History:** RELEASED <07 JAN 2004 by morefirh>; APPROVED <08 JAN 2004 by morefirh>  
**Review Markings:**

Margaret P. Grafeld  
Declassified/Released  
US Department of State  
EO Systematic Review  
04 MAY 2006

**Review Media Identifier:**  
**Review Referrals:** n/a  
**Review Release Date:** n/a  
**Review Release Event:** n/a  
**Review Transfer Date:**  
**Review Withdrawn Fields:** n/a  
**Secure:** OPEN  
**Status:** NATIVE  
**Subject:** KOREAN ECONOMY UP 7.4 PERCENT IN 1975; LESS INFLATION AND GROWTH OF 7 PERCENT TARTETED FOR 1976  
**TAGS:** EGEN, EFIN, MASS, MPOL, KS, MTN  
**To:** STATE  
**Type:** TE  
**Markings:** Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006